Working Paper 108

A Simplified Method for Taxing Multinationals for Developing Countries: Building on the 'Amount B' Proposal to Repair the Transactional Net Margin Method

Michael C. Durst

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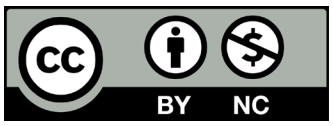

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Summary

This paper considers whether the 'Amount B' proposal currently being negotiated in the Inclusive Framework, for the attribution of fixed remuneration for the 'routine' distribution and marketing activities of MNE affiliates, may offer a useful template for the re-working of the widely used 'transactional net margin' transfer pricing method (TNMM). The TNMM has for years posed severe difficulties for tax administrations around the world, especially in developing countries. The paper focuses especially on two variants of the Amount B proposal which have been offered by Johnson & Johnson and Procter & Gamble, and suggests how a revised TNMM might be expanded to apply to MNE affiliates engaged in activities in addition to marketing and distribution. The paper acknowledges that a restructured TNMM would remain in some ways an imperfect tax administration instrument, and that its construction will involve some unavoidable technical challenges (as would be true of any meaningful reform of rules for the international division of profits for tax purposes). Nevertheless, a restructured TNMM could provide significant relief to hard-pressed developing-country tax administrations, and the paper argues that it should figure among the objectives of the OECD's current efforts at international tax reform.

Keywords: Amount B; Pillar One; transfer pricing; TNMM; MNE taxation; developing country taxation; base erosion and profit shifting; corporate taxation.

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Contents

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Acronyms

ALP	Arm's-length principle
ATAF	African Tax Administration Forum
EBT	Earnings before tax
EOM	Enterprise operating margin
MNE	Multinational enterprise
SG&A	Sales, general and administration costs
TNMM	Transactional net margin method

Introduction

Through its Inclusive Framework consisting of tax administrators from more than 135 countries, the OECD is embarked on an ambitious international tax reform programme prompted by the need to respond to the challenges posed to international tax rules by the digitalisation of the global economy.[1] As predicted in prior studies conducted by the OECD (OECD 2015, OECD 2018), however, it has not been possible to 'ring fence' consideration only to highly digitalised businesses. Instead, the project has evolved to entail a wide-ranging reconsideration of two of the main principles of international tax: (i) the rules on when a multinational enterprise (MNE) can be considered to have a taxable presence in a country; and (ii) the rules governing how the taxable income of an MNE is divided, for tax purposes, among the different countries in which the group's members conduct business, currently laid down in the OECD Transfer Pricing Guidelines. This paper is offered with the understanding that at the time of publication, the outcome of international negotiations regarding the OECD's digitalisation project remains uncertain; nevertheless, regardless of the ultimate fate of the current proposals, they offer important suggestions for international tax reform which are worthy of close analysis.

This paper focuses particularly on one of the OECD's pending proposals relating to transfer pricing, the 'Amount B' proposal under Pillar One for 'fixed remuneration' of MNE subsidiaries that are engaged in 'routine' or 'baseline' marketing and distribution activities. This proposal is of substantial practical importance, especially to the tax administrations of developing countries. Its significance extends beyond taxation of the marketing and distribution subsidiaries to which the proposal is currently addressed. This is because the Amount B proposal in effect offers a possible template for a reworking of the transactional net margin method (TNMM), one of the five transfer pricing methods approved in the OECD Transfer Pricing Guidelines. The TNMM is the most frequently applied transfer pricing method around the world, and it applies not only to the field of marketing and distribution but also to other kinds of business activities including manufacturing and the provision of services, like the operation of call centres and data processing centres.

Although the TNMM is not explicitly mentioned, the Amount B proposal appears designed to address a long-recognised source of failure of the TNMM, especially in developing countries. The problem, as discussed further in section 3.2 below, is that the TNMM requires tax administrations when conducting transfer pricing examinations to perform individualised, expensive, and often fruitless searches for 'uncontrolled comparables'. Suitable uncontrolled comparables are often unavailable due to systematic differences between independent (uncontrolled) companies and members of multinational groups; and these problems have undoubtedly impaired tax administration in countries of all levels of economic development. The difficulties, however, have been greatest for developing countries, which typically have relatively small economies within which to try to locate useful comparables. Also, limited tax administration resources often deprive revenue authorities of access to the commercial databases and specialised personnel that are needed even to attempt comparables searches.

This makes it impossible for developing-country tax administrations to enforce reasonable minimum levels of income from locally operating MNE affiliates, and limit base erosion and

[1] The details of the project have changed over time; the latest version at this time of writing is OECD (2020); for recent discussions see Rukundo (2020) and Hearson (2020).

profit shifting caused by payments to related parties.[2] As the African Tax Administration Forum (ATAF) has pointed out, 'base eroding payments such as excessive interest payments, management fees, royalties and service fees paid by African taxpayers to related entities located in no or low tax jurisdictions… are decimating the tax base of many African countries' (ATAF 2019: 4).

This paper outlines a process to re-engineer the TNMM, along lines suggested by the Amount B proposal, to enhance the ability of tax administrations to control corporate tax revenues, especially in developing countries. The paper begins with an overview of the Amount B concept in the context of the OECD's recent proposals under Pillar One, explaining how the Amount B proposal departs from historical practice under the TNMM. Next, the paper describes and analyses important modifications to the Amount B proposal that have been offered by the MNEs Johnson & Johnson and Procter & Gamble. Finally, the paper outlines a programme of work by which the Inclusive Framework and its subsidiary bodies might re-specify the TNMM, broadly as suggested by the Johnson & Johnson and Procter & Gamble proposals, to provide greater simplicity and certainty to taxpayers as well as tax administrations, especially in developing countries.

I offer these suggestions with three caveats. First, the fashioning of effective reform along the lines suggested in this paper will be technically demanding, posing a particularly difficult challenge at this time when the world's international tax policymaking institutions are heavily burdened due to the coronavirus crisis. Technical challenge is inevitable in any serious proposal to modify profit-allocation rules, and in this instance a modification to the TNMM should result in substantial simplification of transfer pricing administration, with the greatest benefits almost certainly realised in developing countries. Therefore, the inevitable technical challenges should not deter policymakers from the task of redesigning the TNMM, but it is important for policymakers to be realistic in staffing and scheduling the analytical process in the current environment, to ensure that the process is not unduly compressed. Second, although the need for more effective profit apportionment rules is as great as ever, governments in the current economic environment may be wary of changes that might be seen as imposing additional tax on income from inbound investment. The proposal in this paper should not be seen as recommending any particular level of corporate income taxation as appropriate for the post-Covid-19 environment; instead, the proposal is designed to ensure that, when an appropriate level of taxation has been determined by the political process, developing-country tax administrations will have available the technical means of reliably enforcing that level of taxation. Third, I should acknowledge that from the standpoint of long-term tax policy, any reform of the TNMM is at most a second-best proposal; it would perpetuate a 'one-sided' transfer pricing method which arguably should be eliminated from the transfer pricing system in favour of a comprehensive formulary approach based on the principle of unitary taxation.[3] Nevertheless, despite its departure from what might be seen as an ideal policy model, a reform based on the Amount B proposal offers a valuable opportunity to change the TNMM in the current round of international tax reform, in a manner that could greatly facilitate tax administration in developing countries. A reform of this kind could provide valuable benefits in the short term, during which time the international tax system might evolve to a more comprehensively formulaic model.

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[2] The terms 'local affiliate' and 'related party' are used in a broad sense in this paper, to include a part of an MNE group that may be (i) a separate company (subsidiary), (ii) a portion of a separate company (as where a single subsidiary is engaged in more than one business activity) or (iii) a branch of the parent company or of one of its subsidiaries (in tax terms, a permanent establishment).

[3] The TNMM is 'one-sided' in that it requires a minimum level of taxable income from only one affiliate (the 'tested party') of an MNE corporate group. Under a one-sided transfer pricing method like the TNMM, the tested party's required income does not depend upon the profitability of the MNE group as a whole; instead, an arm's-length level of income must be estimated for the tested party on a stand-alone basis. This can be distinguished from the 'profit split' method, in practice used less frequently, which attempts to divide parties' combined taxable income according to an apportionment formula (for example their contributions to intangibles). Proposals for formulary apportionment can be seen, in practical effect, as efforts to build on and extend the profit split approach (Durst 2017, esp. 56-57).

1 The OECD proposals

The Amount B concept is part of the OECD's Pillar One proposals, which are intended to increase the share of taxation of 'market jurisdictions' in international business (OECD 2020: 8). The Pillar One proposals envisage that MNEs could be subject to tax on three different components ('amounts') of their global income in countries where they derive sales revenues.

The first component, 'Amount A', consists of a percentage of the MNE's worldwide consolidated 'residual' (supra-normal) income. The OECD's working assumptions in estimating the impact of the proposals are that the residual would be either 80 per cent or 90 per cent of the MNE's global profits before tax, and Amount A would be 20 per cent of the residual.[4] This share of residual income would be apportioned for tax purposes among the countries in which the group has revenues from sales, based on the proportion of sales in each of those countries. This would apply even to countries where the MNE has no physical presence, so Amount A is seen as creating a 'new taxing right' and its introduction would require changes to tax treaties.

The proposal's use of an apportionment formula, to be applied to the MNE's global consolidated profits, to divide Amount A among countries represents a sharp departure from the OECD's historical approach to the division of MNE income among countries. Until now, the OECD has firmly adhered to the 'arm's-length principle' (ALP), which requires separate assessment of the functions performed by each affiliate, and attribution of profit by reference to comparable independent businesses. Until recently, formulary apportionment was dismissed by the OECD as impracticable (OECD 2017a, paragraphs 1.14-1.32.). This has changed, however, and the pending Pillar One proposal combines elements of formulary and arm's-length pricing.

The Amount A proposal, in its current form, is intended to apply to companies involved in (i) 'automated digital services', and (ii) 'consumer-facing businesses' (OECD 2020:10-11). Also, it would apply only to taxpayers with global revenues above a specified threshold, still to be determined. The remainder of the residual profit would be allocated according to existing transfer pricing rules.

Pillar One also proposes a new method for allocating income to market jurisdictions, described as Amount B. This is independent of Amount A and would apply to an MNE which does have a taxable nexus (i.e., a permanent establishment) in a country. Also, it apparently would not be limited to particular kinds of taxpayers, or to a size threshold, as envisaged for Amount A. Amount B envisages 'a fixed return for baseline distribution and marketing activities' of MNE group members in a country (OECD 2020: 16), sometimes referred to as 'routine' distribution and marketing activities (OECD 2020: 19). The Pillar One proposal also designates as Amount C any profits earned in a country, additional to Amount B, which are properly attributable to marketing and distribution functions performed in that country; Amount C therefore would consist of income attributable to marketing and distribution performed beyond a 'baseline' level (OECD 2020: 8).

The Amount B proposal is notable in its departure from the historical requirement of the OECD Transfer Pricing Guidelines that in benchmarking the income of an MNE affiliate for transfer pricing purposes, tax authorities must attempt comparables searches on a case-by-case basis. Nevertheless, it seems intended that the fixed remuneration prescribed under Amount B will approximate the amounts that might be indicated by comparables searches. It

[4] See the OECD's February 13, 2020 presentation (slide 12): https://www.oecd.org/tax/beps/presentation-economic-analysis-impact-assessment-webcast-february-2020.pdf.

is expected that further development of the Amount B proposal will entail 'benchmarking studies' to establish required minimum income levels for marketing and distribution subsidiaries (OECD 2020: 17). Studies will also consider 'the degree to which there may need to be a differentiation in treatment between industries and regions in order to remain in broad conformity with the ALP' (*ibid*.). Notwithstanding the elimination of the requirement that tax authorities conduct case-specific comparables searches, the OECD considers that the Amount B proposal remains consistent with the ALP, so that the proposal would not require revision of bilateral income tax treaties (*ibid*.).

2 Formulaic methods for Amount B

Two US-based MNEs, Johnson & Johnson (2019) and Procter & Gamble (2019), have suggested ways of determining a distributor's fixed remuneration under Amount B, using a formulaic method that takes into account the system-wide profitability of the MNE group. Both envisage that the local distributor's required level of profitability would be computed as a percentage of the entire group's overall profitability: under the Johnson & Johnson proposal, in part, and under the Procter & Gamble proposal, in full.[5]

Under the Johnson & Johnson proposal, a local distributor would be expected to earn a minimum operating margin (i.e., ratio of operating income to sales revenue), computed as a percentage of the MNE's global consolidated enterprise operating margin (EOM). The percentage would vary according to the intensity of the local distributor's business activities, as measured by the ratio of the local distributor's spending on sales, general and administration costs (SG&A) to local revenues. That is, the more intensive the distributor's marketing and distribution activities, the larger the percentage of EOM the distributor would be expected to earn. Conceptually, the Johnson & Johnson approach combines two different models of profit allocation: (i) the 'unitary' model, because the local affiliate's allocated profit depends in part on the group's system-wide profitability, and (ii) the 'separate entity' model, because the fraction of system profitability used to determine the local affiliate's target profit also depends on the local affiliate's own intensity of SG&A expenses as compared to local revenues.

Johnson & Johnson propose a matrix of minimum local operating margins as indicated in Table 1. They describe the figures in their proposed matrix as an approximation of income levels they believe would be reasonable at varying levels of system-wide profitability and local-taxpayer SG&A activity, based on their experience of transfer pricing under the ALP (Johnson & Johnson 2019: 4). It is notable that their matrix does not appear to be based directly on searches for local independent comparables. Instead, their numbers appear to be based broadly on the company's judgement, based on experience under the ALP. They explain that the specific parameters of their matrix are only illustrative and suggest that the numbers ultimately decided could differ based on further empirical analysis by the OECD (Johnson & Johnson 2019: 3).

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5 For a precursor to the Johnson & Johnson and Procter & Gamble 'formulary' proposals, see Durst 2016 and Durst 2017, in which I suggested a template for a revision of the TNMM based on a group's system-wide profitability. The current paper, based in large part on ideas raised by the Johnson & Johnson and Procter & Gamble proposals, modifies and adds detail to my earlier proposal.

A recent tax proposal in the United Kingdom also has some similarities to the proposals described in this paper. The Finance Bill 2020 ss.47-8, as available as of this writing, would give taxpayers the option of computing their digital services tax, which is 2 per cent of the local affiliate's total revenues, instead as an amount consisting of 80 per cent of the UK operating margin multiplied by the local affiliate's revenues. The operating margin is defined as UK revenues less attributable expenses, excluding interest and depreciation. The Finance Bill is available at https://publications.parliament.uk/pa/bills/cbill/58-01/0114/20114.pdf; for discussion, see Goulder 2020.

Table 1 Example of formulaic allocation to distributor under Johnson & Johnson proposal

ROS target	Low activities SGA/S <20%	Medium activities SGA/S >20% & <40%	High activities SGA/S >40%
EOM	Target 12.5%	Target 15%	Target 17.5%
5%	0.6%	0.8%	0.9%
10%	1.3%	1.5%	1.8%
15%	1.9%	2.3%	2.6%
20%	2.5%	3.0%	3.5%
25%	3.1%	3.8%	4.4%
30%	3.8%	4.5%	5.3%
35%	4.4%	5.3%	6.1%

Source: Johnson & Johnson 2019: 3.

Under the Johnson & Johnson proposal, a taxpayer would be required to earn income within a range of plus-or-minus ten per cent of the income level determined in the table. A floor would be placed on the required income level in the event of consolidated group losses, so that the distributor would still break even or earn perhaps 0.5 per cent on sales (*ibid*. 4). There would also be a ceiling on the required income level in the event of very high group profits. Specifically, Johnson & Johnson suggest that the combined required level of income under both Amounts A and B of the OECD proposal should not exceed 20 per cent of the consolidated system profit (*ibid.*: 4).

Johnson & Johnson present their Amount B proposal as a safe harbour, rather than as a mandatory minimum income level for taxpayers (*ibid*.: 2). This idea has been strongly opposed by the ATAF (ATAF 2019: 3) and probably would be unacceptable to many developing countries. There is no reason, however, why the proposal could not be fashioned as a mandatory tax rule. Johnson & Johnson describe their proposal as motivated in part by their recognition of 'the limited resources of developing countries to perform detailed comparable company analysis' (*ibid*.: 2).

The Procter & Gamble proposal is similar in structure, but different in detail. Like Johnson & Johnson, Procter & Gamble describe their Amount B proposal as designed to address the administrative difficulties faced by developing countries (Procter & Gamble 2019: 2). It is based on the following formula:

> '1. For distributors where there is little or no system profit, the distributor would earn a guaranteed 1% of sales market return up to the point where 15% of system profit provides a greater return to the distributor (the switch over point is approximately 7% of pre-tax margin).
>
> 2. A return equal to 15% of system profit would continue up to average MNE global profitability of approximately 12.5%.
>
> 3. For MNEs that have system profit above 12.5% the formulaic approach would allocate 18% of system profits in excess of 12.5%.'
>
> (Source: Procter & Gamble 2019: 13, footnote omitted)

In short, the taxable income of the local affiliate would be calculated by applying a profit margin on local sales revenue of 15 per cent of the global profit rate of the MNE of which it is

a part, but with a minimum taxable income of 1 per cent of local sales revenue. Once the MNE reaches a global profit margin on sales of 12.5 per cent (the recent average for large MNEs in the S&P Global 1200) (*ibid*.: 13 n.15)), the local affiliate would receive a higher proportion of the global profit (18 per cent) on the additional profits.

The Procter & Gamble proposal therefore would determine the local distributor's required profit level by reference only to the MNE's consolidated profitability, without including as a variable the marketer's level of local business expenses, as under the Johnson & Johnson proposal. The Procter & Gamble proposal accordingly conforms to a 'unitary' model of profit allocation. Its aim is 'to calculate a distributor return for a variety of business models in a formulaic way' (*ibid*.: 12).

Procter & Gamble describe their proposed numbers as based on the experience of transfer pricing economists from various regions and firms, and on a review of their own advance pricing agreements in all the regions in which they operate, and hence as consistent with the ALP (*ibid*.: 12). Like Johnson & Johnson's, their proposal is not based on formal searches for comparable independent firms.

The Procter & Gamble proposal incorporates a significant improvement, from the standpoint of tax administration, over the Johnson & Johnson proposal. It would generally benchmark taxpayers' income levels based on their earnings before tax (EBT), rather than on the enterprise operating margin (EOM). The term 'operating income' indicates income before deduction of interest, as used also in the OECD's current Transfer Pricing Guidelines governing the TNMM (see section 3.3 below). The switch to EBT would have the effect of enabling the TNMM for the first time to control profit shifting through the payment of intragroup interest expenses (in addition to other kinds of base-eroding payments like management fees). This is an important innovation and will be discussed further below in connection with proposals to restructure the TNMM. In addition, the Procter & Gamble proposal would not function as a safe harbour, but would establish 'an easy to administer, formulaic, fixed minimum return' for affiliates engaged in distribution (*ibid*.: 5).

3 The TNMM

3.1 Overall structure of the method

The TNMM is the most frequently used transfer pricing method, by both taxpayers and tax administrations, around the world (Collier and Andrus 2017: 111-2). It is used to benchmark the income attributable to operating affiliates of MNEs under the ALP, by reference to the income earned by comparable independently owned firms (OECD 2017a, paras. 2.64-2.113). For example, a beverage company's distribution subsidiary might report on its tax returns an operating margin (ratio of operating profit to sales revenue) of 1.0 per cent. The tax administration might determine, by reference to commercially available databases, that comparable independent beverage distributors in the same region in the same period typically earned operating margins of at least 2.5 per cent. The tax administration would therefore propose an adjustment, increasing the distribution subsidiary's operating margin by 1.5 per cent.

This assumes that the tax authority is able to identify independent distributors of beverages that are reasonably close to the controlled distributor (the 'tested party') in their business model (e.g., in having a relationship with only a single supplier of branded beverages), the scale of operations, and other relevant factors. In actual practice, as outlined below, reasonably close comparables often cannot be found. Further, even if some comparables can be found, it is quite possible that the financial results of those comparables will be

spread out along a wide range, owing to differences in the financial success of the various businesses, so that no clear arm's-length range can be determined (Wills 1991; Durst and Culbertson 2003: 108-114).

The TNMM is typically used to benchmark not only distribution subsidiaries (which are the specific focus of the Amount B proposal), but also companies conducting activities such as manufacturing ('contract manufacturers' or 'toll manufacturers' on behalf of MNE groups), and service-providing subsidiaries, such as customer call centres or data processing centres. These are generally described as 'limited risk' affiliates, and typically contract to transfer all their income above these 'routine' levels to affiliates in low- or zero-tax jurisdictions through payments of interest, royalties, and management fees or other service fees (Durst 2019: 50-52).

Different 'net profit indicators' might be used rather than the operating margin for benchmarking a particular kind of subsidiary.[6] The choice of a net profit indicator depends on the nature of the business and the need to avoid basing the indicator on the pricing of transactions between related parties in the MNE group. For example, if a distribution subsidiary sells almost entirely to unrelated customers, it can appropriately be benchmarked using the operating margin (ratio of operating income to sales), because its revenues are determined by sales to third parties. However, this would not be the case, for example, for a manufacturing subsidiary that sells all its output to the parent company; so in that case an indicator should be used that does not depend on sales revenue, such as the return on total costs (ratio of operating profit to total costs). However, if a significant part of these costs is due to supplies from related parties, the return on assets (ratio of operating income to the balance-sheet value of the subsidiary's assets) could be used.

Regardless of the net profit indicator used, the method is essentially the same. First, the transfer pricing analyst, who might be a tax inspector conducting an examination or a private-sector consultant preparing a tax return, must perform a 'functional analysis' of the tested party to determine what kinds of 'uncontrolled comparables' (independent local firms engaged in similar activities) might be identified for benchmarking purposes. Secondly, based on the functional analysis that has been performed, there must be a search for uncontrolled comparables in commercially available financial databases. Thirdly, a comparison of the income levels of the comparables with the income levels of the tested party determines whether an income adjustment is required.

The OECD Transfer Pricing Guidelines repeatedly insist that the functional analysis and the comparables search must be conducted on an individualised basis, based on all the facts and circumstances of the tested party. (The phrase 'facts and circumstances' occurs 118 times in the Guidelines.) Hence, the fixed remuneration regime envisaged in the Amount B proposal represents an important departure from historical OECD practice.

The methodology of the TNMM has become standardised around the world. Under the OECD Transfer Pricing Guidelines, the TNMM is supposed to be used to benchmark the incomes only of subsidiaries that are 'routine' in their operations, in that they don't bear substantial business risks or make 'unique and valuable contributions' to the MNE's business (OECD 2017a, para. 2.65). In practice, however, the TNMM almost certainly is applied more widely than envisaged under the Guidelines; indeed, one commentator in India has quipped that the TNMM is used 'in 11 out of 10 cases' (Vaidya 2014).

[6] They are called 'profit level indicators' in the U.S. regulations (Treas. Reg. section 1.482-5(b)(4)), and 'net profit indicators' in the OECD Transfer Pricing Guidelines (OECD 2017a, paragraph 2.82).

3.2 Failure of TNMM in developing countries

Despite the frequency of its use, it is widely acknowledged that the TNMM has failed to enable tax administrations to enforce reasonable levels of income of MNEs' operating subsidiaries, especially in developing countries. There are three main reasons for this failure. Firstly, as a matter of business economics, the MNE affiliates in a country are likely to differ systematically from independent entities in the same industry in that country. In particular, their membership in MNEs with global scale and scope of operations is likely to significantly reduce their unit costs. Secondly, MNEs can make large investments in advanced technology, either through acquisition or through their own research and development (R&D) conducted on a worldwide scale. Consequently, their products and services often are not truly comparable with those of smaller local firms. Thirdly, they have considerable market power, often because of their use of popular consumer brands. Hence, even when careful database searches can be performed, it is hard or impossible for tax administrations to find appropriate 'uncontrolled comparables', as local independent firms are likely to be smaller and less profitable. The problem of the unavailability of useful comparables affects tax administrations in countries at all levels of economic development. However, it is almost certainly most severe in developing countries with smaller economies and therefore smaller pools of potential comparables.

A second important problem is that even attempting to apply the TNMM requires tax administrations to invest in expensive commercial databases and specialised training of personnel. Most developing countries do not have access to either the databases or the trained personnel.[7] Therefore, while all countries probably have encountered difficulties in applying the TNMM, many developing countries are in effect precluded from using the TNMM at all, leaving their tax administrations essentially without recourse against profit shifting by MNE subsidiaries operating in their jurisdictions. The OECD and other international organisations have referred repeatedly in recent years to the severe problems faced by developing countries in identifying comparables,[8] but the Amount B proposal represents the first suggestion by the OECD that adequate benchmarking for transfer pricing purposes might not require case-specific attempts by tax administrations to locate and analyse uncontrolled comparables.

It should be recognised that reform of the TNMM as envisaged in this paper to provide for fixed remuneration would not be a panacea for all the transfer pricing difficulties faced by developing countries. There are important areas of economic activity in developing countries which pose serious international tax problems, in which the TNMM is generally not used. These include (i) natural resource extraction; (ii) the production of agricultural commodities; and (iii) banking and other financial services, including insurance. Nevertheless, re-specifying the TNMM as envisaged in this paper should provide substantial simplification for developing-country tax administrations in the taxation of a wide range of MNE subsidiaries engaged not only in marketing and distribution, but, as I suggest below, also those engaged in manufacturing and the provision of services.

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7 Presenting Procter & Gamble's proposal at the OECD public consultation, its senior tax executive Tim McDonald pointed out that more than half of the countries in the OECD's Inclusive Framework have no access to comparables databases and to transfer pricing economists to work with the data (Finley 2019; Picciotto 2019). Katherine Amos of Johnson & Johnson made a similar observation: 'There are so many countries out there that have nobody that understands transfer pricing right now. These governments can't afford the really expensive databases.' (Finley 2020b). See also BEPS Monitoring Group 2019: 8: 'In Africa for example the introduction of transfer pricing rules is recent and partial. Only 18 out of 55 countries now have detailed regulations, and many even of these have not yet formulated policies for enforcement. This approach is not useful for the large majority of developing and often post conflict countries, which face much more basic problems of tax administration.'

8 See OECD 2014a: 57-58; OECD 2014b; Platform for Collaboration on Tax 2017.

3.3 The TNMM and income-shifting through interest payments

A word should be said at this point about the shortcomings of the TNMM, in its current form, in seeking to control taxpayers' profit shifting through related-party interest payments. Under the OECD Guidelines, the TNMM establishes minimum levels of 'operating income' which particular businesses must earn in order to be seen as complying with the ALP (OECD 2017a, paragraph 2.83-2.86). 'Operating income' in accounting terminology is a measure of a company's income (with minor exceptions) *before* the payment of interest on indebtedness. Thus, the TNMM generally does not limit payments of interest by taxpayers to related parties. This reflects that historically transfer pricing rules generally have not been used to control payments of interest to related parties. Instead, the control of related-party interest expenses has generally been attempted by other tax rules, like 'thin capitalisation' and 'interest stripping' rules (Durst 2019: 53-54; Durst 2015).

As part of its BEPS project, the OECD has recommended that countries adopt stronger interest stripping rules, and many countries have done so.[9] However, even these can allow significant continued profit shifting using interest payments, and many countries, especially in the developing world, have not yet adopted such rules. For these reasons, it would be important for a reformed TNMM to limit deductions for related-party interest expenses, as well as deductions for other kinds of related-party payments.

Extending the TNMM to control interest deductions should be straightforward as a technical matter: benchmarking should occur not based upon 'operating income', as under the current TNMM, but rather on EBT (that is, income *after* payment of interest), as under Procter & Gamble's Amount B proposal discussed above. This would make a reformed TNMM much more effective in controlling base erosion.

4 Policy considerations in reforming the TNMM

The TNMM is based on a longstanding model of the international division of income for tax purposes in which the operating affiliates of an MNE around the world are apportioned 'routine' remuneration for their activities, and the remaining 'residual' income is apportioned elsewhere, for example to the MNE's headquarters jurisdiction where the group's main value-creating activities are seen as taking place. This model for the division of income between parent and subsidiary originated during the period of colonialism, and it has been criticised as 'mercantilist' in that it tends systematically to limit the profitability, for tax purposes, of MNE affiliates operating in foreign host countries (Wells and Lowell 2013: 10-13). During the recent debates over Pillar One, some commentators, including the G-24 group of developing economies, recommended an outcome for Pillar One that would apportion all of an MNE's income by applying an appropriate formula to the global consolidated income, without distinguishing between 'routine' and 'residual' income.[10] Under this approach, there would be no role for the TNMM or any other method that seeks to benchmark income by reference to comparables.

It should be noted here that the Johnson & Johnson and Procter & Gamble versions of Amount B, while formulaic in that they would base an MNE affiliate's required income on the

[9] A summary of the OECD's Action 4 recommendations, and comments on different countries' actions to implement the recommendations, can be found at www.oecd.org/tax/beps/beps-actions/action4/

[10] E.g., G-24 Group of Governments 2019; BEPS Monitoring Group 2019; ICRICT 2019.

MNE group's consolidated system profit, would nevertheless assign to the affiliate a fixed level of income based on estimates of what would be determined under the ALP. This approach therefore is not consistent with the kind of formulary regime that the G-24 and other commentators have been advocating. Arguably, any proposal based on assigning affiliates 'fixed remuneration' as opposed to a formulary share of groupwide income risks unduly limiting developing countries' shares of MNEs' global incomes.[11] Also as a policy matter, the concept of 'routine' income which underlies TNMM (and the Amount B proposal) can be criticised as intellectually flawed. Arguably, the incomes of all members of a multinational group benefit from groupwide assets like intangibles and economies of scale, so that limiting certain affiliates to 'routine' levels of income is unwarranted.[12]

Despite the arguments for a full, longitudinal formulary apportionment, however, I think it likely that the discussions on Pillar One will continue to assume a split between an MNE's routine and residual income, and that there will continue to be a role for some version of the TNMM. In part, this reflects the view that the concept of 'routine' income – if it is implemented by enforceable rules – has the practical effect of establishing at least a minimum level of tax for an affiliate, regardless of the global economic performance of the MNE group as a whole. The TNMM, at least if it operates effectively, can be seen as placing a floor, as well as a ceiling, on developing countries' income from MNE operations. There may be merit to the view that the kind of steady but limited income that should, in theory, be ascribed to developing-country local affiliates under the 'routine' income theory has in time come to reflect a durable political balance between the desire of developing countries for tax revenues, and their desire to encourage foreign direct investment.[13] It is possible that at least some developing countries would not wish to press for a regime affording them a full longitudinal share of an MNE's group profits, instead of the more limited but steady income flow of the 'routine profit' approach, especially if the method for ensuring the maintenance of that flow can be made more effective. Hence, improvements to the TNMM could provide worthwhile benefits to developing countries, notwithstanding the questions that can validly be raised concerning the concept of 'routine' income on which the TNMM is based.

It also should be borne in mind that the current global economic downturn as a result of the coronavirus pandemic may have the effect of imposing limits on the model of guaranteed compensation for affiliates' 'routine' activities, regardless of the performance of the multinational group as a whole, since MNEs facing global profit declines or losses would press for an alternative (Finley 2020a). The model discussed in this paper for a formulaic TNMM, with guardrails for very high or very low system income, might respond appropriately to these pressures, since under this approach an affiliate's required income would be reduced, but not below zero, in cases of system-wide losses.

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11 This is especially true to the extent that countries now apply the TNMM even to local MNE affiliates with activities that apparently extend beyond the merely 'routine' – and are likely to continue doing so even under a reformed TNMM.

12 See ICRICT 2019: 2: '[T]he approach of separating "residual" from "routine" profits to determine Amount A is flawed on three grounds: 1) It is not possible to distinguish conceptually, as the OECD proposes, between the 'routine' (i.e. locally generated) and 'residual' (i.e. internationally generated) profits of a MNE, as *all* profits are essentially the result of the global activities of the firm. Moreover, the OECD has not presented either a robust methodology for separating the two, let alone theoretical foundations on which such a distinction might rest, nor the data with which this might be rigorously done. 2) Existing transfer pricing rules are not fit to determine "routine profits" in the way that the OECD proposes, as demonstrated by the large number of associated tax disputes under the existing BEPS system. 3) In a well-designed corporate tax system the cost of capital is fully costed (with often more than economically justifiable deductions for depreciation and interest), so that there is no disincentive to enterprise investment and sustainable growth. Thus, for practical purposes, only excess "pure" profits (i.e. economic rents) are taxed, and those economic rents are associated with the global activities of the MNE. As such, *all* profits of MNEs should be apportioned through a formula. This will truly simplify the system and obviate the need for additional profit sharing rules (i.e. Amount B and C).'

13 Hearson (2020) notes with respect to the revenue potential of the Amount B proposal, at least in the short term: 'Depending on the formulae agreed it could attribute some additional profits towards the market country, but these are most likely profits that that country currently misses out on due to the challenges of enforcing existing rules; it does not represent a change in the political settlement underlying those rules.' Hearson 2020: 5-6.

Another issue is whether a formulaic TNMM, based on the global profitability of an affiliate's multinational group, would be considered compatible with existing tax treaties. (The OECD has expressed the view that the Amount B proposal in its current form, without a formulary component, would be consistent with existing treaties (OECD 2020: 17); the question addressed here is whether the inclusion of a formulary component should affect that conclusion.) In particular, a taxpayer might argue that a government's transfer pricing adjustment based on the formulary method exceeds the government's authority under the language of Article 9 of both the OECD and UN Model Conventions, which permits only adjustments made to conform a taxpayer's intragroup arrangements 'with those that would be made by independent enterprises'.[14] In support of this position, it might be argued that adjustments based on groupwide profitability do not necessarily bring the taxpayer's results closer to those that would be obtained by unrelated parties transacting at arm's length. Against this, however, existing profit split methods already take groupwide profitability into account, and those methods generally have been seen as consistent with existing treaty rules. Moreover, although the envisaged revised TNMM would not require comparables searches on an individual-taxpayer basis (on the grounds that requiring case-by-case searches has proven administratively infeasible, especially for developing countries), the revised method would nevertheless be intended to reach results approximating those that would be reached under a comparables-based method. In essence, tax administrations adopting the new method would be seeking to preserve the objective of arm's-length pricing while remaining within the boundaries of what is administratively practicable. For this reason, while the possibility of a contrary result cannot be eliminated, I would expect national courts generally to find the envisaged revised TNMM to be consistent with the language of today's Article 9.

The likelihood of this result will be increased to the extent that the OECD, and national governments implementing the new method, make clear their intention to achieve results, within the constraints of administrative feasibility, similar to those that would be obtained using a comparables-based analysis. In addition, if the OECD and United Nations decide to promote treaty changes to accommodate other aspects of the Pillar One proposals (for example, to facilitate the new approach to nexus and profit allocation envisaged under Amount A), they should also include language to eliminate any doubt concerning the permissibility of a revised TNMM under Amount B.

5 The building blocks of a re-engineered TNMM[15]

Although revision of the TNMM along the lines discussed in this paper is conceptually relatively straightforward, the technical task will be complex, labour-intensive, and politically challenging. It will entail demanding requirements of both economic analysis and legal drafting; and also will require the exercise of considerable subjective judgement, given the approximation and imprecision inherent in any profit allocation method. The process may well prove controversial, and in fairness to stakeholders, the process should be transparent.

I recommend that the revised TNMM be expanded beyond the scope of the current Amount B proposal, to apply to MNE subsidiaries in addition to distributors (in particular, manufacturing and service-providing subsidiaries of MNEs). This expansion should offer

[14] OECD 2017b and United Nations 2017.

[15] A table, comparing key aspects of (i) the current TNMM; (ii) the OECD's Amount B proposal in its current form; (iii) the Johnson & Johnson proposal; (iv) the Procter & Gamble proposal; and (v) this paper's proposal, is provided as an appendix to this paper.

substantial advantages to developing countries, but it will also compound the work of legal and economic analysis, and perhaps political negotiation, that will be required to implement the proposal. In particular, as detailed further below, expanding the scope of the revised TNMM to encompass manufacturers and service providers, in addition to distributors, will require the specification of additional formulas for use with net profit indicators other than the return on sales. It might be prudent, however, for the Inclusive Framework to proceed first with a specification of a modified TNMM for distributors only, as envisioned now under the Amount B proposal, and only after that exercise has been successfully completed to perform the analytical work needed to extend coverage of the revised TNMM to additional categories of taxpayers (and net profit indicators). Distributors typically comprise an important category of taxpayers in themselves for developing countries, so that completing a revised TNMM for distributors only would constitute a valuable first step in improving transfer pricing administration. The lessons learned from completing the work involving distributors should prove valuable in taking the next steps toward reform of the TNMM for other kinds of taxpayers.

Methodologically, I suggest that the re-specification of the TNMM follow the 'formulaic' model of the Johnson & Johnson and Procter & Gamble proposals, with guardrails provided for instances of very high or very low system profitability, rather than what appears to be the 'centralised comparables search' model of the OECD's current Amount B proposal. The approach of centralised comparables searches would seem to invite difficulties, for several reasons. First, it is not clear whether the centralised comparables searches would be performed by each national tax administration, or perhaps by regional tax organisations like ATAF, or perhaps on a globally centralised basis by the OECD. Assigning this function to the OECD, or even to regional tax organisations, could involve sensitive questions of national sovereignty; whereas assigning the task of performing comparables searches to national tax administrations could impose prohibitive costs on some countries, especially developing countries with limited tax administration resources.

Second, a revised TNMM based on centralised comparables searches would perpetuate the illusion that comparables searches are capable of providing precision of results with respect to transfer pricing questions, and some taxpayers might challenge the levels of fixed remuneration assigned to them under the revised TNMM, by arguing their circumstances differ from those of the hypothetical taxpayer on which the centralised comparables search was based. Moreover, there might be an expectation that centralised comparables searches would need to be updated from time to time, which could be an expensive and politically controversial process.

While not entirely avoiding these difficulties, the formulaic approach to a revised TNMM, in which the required fixed remuneration varies according to the MNE's system-wide profitability, seems more likely to be politically stable. Under the envisaged formulaic approach, although the formulas would be designed to approximate arm's-length results, no claim would be made that the formulas track precisely the arm's-length remuneration levels appropriate to any particular entity. No attempt would be made, when specifying the formulas to be used to determine fixed remuneration under the different net profit indicators, to provide different results for taxpayers in different industries, or in different geographic locations. The process of specifying the formulas would, to be sure, involve subjective judgement, and would continue to depend on comparables searches to verify that the results of the formulas conform reasonably well to the results that would be obtained under the TNMM. There may well be controversy, from the standpoints of both taxpayers and tax administrations, about the specifications of the different formulas. The controversy, however, should be less than it would be if the fixed remuneration for each net profit indicator were to be determined by explicit comparables searches that purport to specify different levels of fixed remuneration for taxpayers in different industries and different geographic locations. Also, given their frankly

approximate nature, there should be less of an expectation that the formulas would need to be updated periodically.

Of course, the success of even an avowedly judgemental, formulaic approach to a re-specified TNMM will depend on the political willingness of MNEs as well as tax administrations to accept the large degree of approximation that is built into the approach. If taxpayers instead insist on the level of precision that (supposedly) was afforded through case-by-case comparables searches under the old TNMM, then the envisaged simplification will not succeed.[16] Essentially, multinational businesses will need to be willing to forgo some degree of ostensible precision in the measurement of their net incomes in the interests of promoting a more administrable tax system, especially for developing countries.[17]

In structuring the revised TNMM along formulary lines, I suggest that the formulas to be specified include only system-wide profitability as a single independent variable, as under the Procter & Gamble approach. In particular, I suggest that to avoid saddling local tax administrations with the need to audit affiliates' expenses, the formulas should not incorporate the tested party's 'activity level' as an independent variable, as under the Johnson & Johnson proposal, unless it is determined that adding the activity variable is necessary in order for the formula to yield results that taxpayers and tax authorities would consider reasonable.

The task of deciding which net profit indicators ultimately should be included in a revised TNMM will be challenging and will require knowledge of the technical traditions of practice that have accumulated over the past 25 years under the TNMM. The OECD Guidelines describe a number of different possible net profit indicators for use with the TNMM.[18] These include the return on sales (ROS), the return on total costs (ROTC), the return on assets (ROA), the return on capital employed (ROCE), and the 'Berry ratio' (ratio of gross profit to operating expenses).[19] Some of these are used more frequently than others, and it may be sufficient for a revised TNMM to provide formulas for only a few, such as the return on sales, the return on assets, and the return on total costs. In addition, those constructing the revised method will need to specify which kinds of businesses (e.g., distributors, manufacturers, and service providers) can be benchmarked, using which net profit indicator.[20]

The success of the revised method will depend heavily on whether the list of net profit indicators to be allowed, and the categories of taxpayers to be benchmarked by a given indicator, can be kept relatively short – e.g., whether the same formula can be specified for all manufacturers. In general, the number of categories should be kept to a minimum, in

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16 Procter & Gamble said of its proposal (which encompassed only one net profit indicator, for marketing and distribution): 'We acknowledge that a formulaic approach may not accurately describe all industry and taxpayer circumstances but could be refined to describe perhaps 80% to 90% of all outcomes. This is the inherent trade-off in the adoption of a simplified formulaic method.' Procter & Gamble 2019: 12.

17 Thus, political support for a more administrable TNMM will require the exercise of corporate social responsibility on the part of many global businesses. The efforts of Johnson & Johnson and Procter & Gamble in proposing revised versions of Amount B are reflective in themselves of a commitment to corporate social responsibility. For recent discussion of the necessary role for corporate social responsibility in tax policymaking affecting developing countries in the post-BEPS era, see Durst 2019: 113-127.

18 See generally OECD 2017a at paragraphs 2.92-2.108.

19 For the reasons given in section 3.3 above all the profit indicators should be based on the measure of Earnings Before Tax (EBT), instead of Operating Income as under the current TNMM. (For example, under the revised TNMM, the Return on Assets (ROA) should be based on the ratio of 'earnings before tax' (that is, earnings *after* payment of interest, but before tax) to assets, rather than the ratio of operating income to assets as under the current version of TNMM. Similarly, the widely used Operating Margin net profit indicator should become the ratio of EBT to sales.

20 Also, rules will be needed to prescribe whether the revised TNMM will be based on consolidated group profitability at the highest level of aggregation, or whether profitability should be segmented by product line. I would suggest taking the simpler, aggregated approach, as the accounting methodology for segmenting profits by business line might be subject to controversy.

order to limit conflicts over the specification of the different formulas. Again, taxpayers as well as tax administrations will need to be willing to exercise political forbearance if the desired simplification of TNMM is going to succeed.

Even if the lists of net profit indicators and of the different categories of businesses are kept relatively short, guidance will be needed to specify the application of the new method to different kinds of businesses. This will need to be based on the particular business functions performed by the taxpayer (e.g., distribution, manufacturing or the provision of services), and on whether the taxpayer's inputs are purchased primarily from related parties (so that a cost-based net profit indicator cannot appropriately be used) or its output is sold largely to related parties (so that a sales-based net profit indicator cannot appropriately be used). Guidance will also need to address the situation of affiliates that perform more than one function (e.g., manufacturing as well as distribution). This kind of guidance will generally be similar to that already included in the OECD Guidelines governing the current TNMM.

In addition, guidance will need to specify what is included in the denominators of the various profit indicators that are specified under the new method: for example, what is included in 'revenue' (e.g., should product returns and refunds, and foreign currency gains and losses, be taken into account), 'costs' (e.g., should depreciation and amortisation be taken into account?), and 'assets' (e.g., should only tangible property, cash and cash equivalents be included?). Tax administrations will need, on audit, to verify that taxpayers have properly computed these amounts; this will involve some administrative burden, but not nearly as much as required for case-by-case comparables searches and detailed functional analyses, which will no longer be needed under the proposed new method.[21]

A crucial part of the quantitative evaluation of the revised TNMM will be to estimate the revenue effects of the new method, particularly in developing countries. This will involve comparing the projected tax to be paid under the new method with the tax paid under the current, less administrable TNMM regime. The comparison will require reference to firm-level data, including data from tax returns filed in countries where companies have been subject to tax in recent years. Compiling the necessary revenue estimates will be a demanding task, and probably should involve experts from more than one international organisation, perhaps under the auspices of the Platform for Collaboration on Tax. Revenue estimates might first be performed for the new method governing distributors, which would be the first of the new methods to be specified.

Assuming that all countries do not adopt the new TNMM simultaneously, provision will need to be made for resolution of possible claims of double taxation between tax administrations of countries that have, and have not, adopted the new method.[22] Because, generally, the income levels required under the new method should be broadly similar in magnitude to the income levels required under the existing TNMM, the new method should not generate an intractable burden of double tax controversies. This is especially likely to be true if countries that have not adopted the new method generally exercise restraint in challenging MNEs that have complied with treaty partners' rules under the revised TNMM. This will be more likely if the revised TNMM has been approved by consensus, or a large majority, in a body like the Inclusive Framework. To the extent that double tax controversies do arise, they should be negotiated and resolved similarly to double tax controversies under the existing TNMM. The current system for resolving claims of double taxation is far from perfect (Picciotto 2016), but

[21] Relatively detailed guidance defining terms like 'revenue', 'costs' and 'assets', and corresponding needs for verification on audit of taxpayers' computations of these amounts, will also be necessary in connection with a comprehensive system of formulary apportionment, should one ultimately be adopted. An entirely simple system of profit apportionment is not possible under an income tax, whether formulary or arm's-length; all that can be hoped for is relative simplicity and administrability.

[22] In some instances in which the new TNMM would be applied, the party dealing with the developing-country affiliate is likely to be a zero- or very low-tax group member, so that double-taxation concerns would not be significant.

the widespread adoption of a revised TNMM based on a formulary approach, rather than on case-by-case comparables analysis, should reduce rather than increase the incidence of conflicts.

6 Conclusion

The Amount B proposal, which would affect rules for taxation of marketing and distribution affiliates of MNEs, provides a welcome opportunity for re-examination of the OECD's widely used TNMM transfer pricing method. This method applies to a broad range of MNE affiliates' local activities, not only marketing and distribution but also manufacturing and the performance of services for related parties, and has taken on a very prominent role in transfer pricing practice around the world. The TNMM, although designed to curtail taxpayers' base-eroding payments to related parties, has in practice failed to do so, especially in developing countries, which in many cases do not have access to the commercially maintained financial databases and specialised tax administration personnel that are needed even to attempt to apply the method.

Building on comments that have been submitted to the OECD on Amount B by MNEs Johnson & Johnson and Procter & Gamble, this paper suggests reforms to the TNMM which would relieve tax administrations of the burdensome, and in the case of many developing countries infeasible, requirement to perform comparables searches on a case-by-case basis when conducting transfer pricing examinations. The change should markedly increase the ability of many developing countries to control base erosion and profit shifting by MNEs operating in their jurisdictions.

The envisaged reforms will place substantial demands on the technical expertise and political judgement of those specifying the new rules. Importantly, the success of the reforms will depend on the political willingness of both taxpayers and national tax authorities to accept avowedly approximate formulas for the benchmarking of taxpayers' incomes, in lieu of the putative precision of the case-by-case comparables analyses that are now required under the OECD Transfer Pricing Guidelines.

The suggested reforms will not produce a perfect tax system. Instead, the reforms will perpetuate a one-sided profit allocation method, the TNMM, which can be criticised as inherently limiting the tax bases of developing countries. A more fully formulary (unitary) tax system, in which taxable income is divided according to a single formula among all members of a multinational group doing business in a country, arguably would produce fairer results, especially for developing countries. Nevertheless, the revised TNMM suggested here should empower developing-country tax administrations significantly compared to their current situation; and the resulting levels of taxable income in developing countries may approximate a desirable political balance, at least for the foreseeable future, in terms of weighing countries' need for tax revenues against their desire to maintain a favourable tax environment for inbound investment. The suggested reforms therefore would represent only an incremental step toward improvement of the world's international tax system for the future – but a step that could yield significant advantages for tax administrations around the world, especially in developing countries.

Appendix

Comparison of different approaches to 'Amount B' reform

	Requires tax administration to perform case-by-case comparables analysis?	Requires centralised comparables searches by a tax agency?	Variables included in formula?	Guardrails provided against losses, very high results?	Limits intragroup interest payments?
Current TNMM	Yes	No	N/A	N/A	No
Amount B proposal as currently articulated by OECD	No	Yes	N/A	N/A	Not specified
Johnson & Johnson proposal	No	No	System-wide profitability, local activity	Yes	Not specified
Procter & Gamble proposal	No	No	System-wide profitability	Yes	Proposal suggests yes
This paper's approach	No	No	System-wide profitability	Yes	Yes

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